COMMITTEE ON THE BUDGET
MAJORITY CAUCUS
U.S. House of Representatives
107th Congress — Washington, DC

BRIEFING POINTS

THE IMPERATIVE OF SPENDING RESTRAINT

CBO'S BUDGET AND ECONOMIC UPDATE FOR FISCAL YEARS 2003-2012

27 August 2002

SUMMARY

The budget update released today by the Congressional Budget Office [CBO] reaffirms the need to restrain Government spending beyond urgent priorities. CBO projects declining deficits for the next 3 years, and a return to budget surpluses by 2006, under current-law rates of spending growth. The figures assume the continuation of one-time emergency spending – such as the supplemental terrorism response bill recently enacted – without which the budget would be back to surplus a year earlier. The figures do not, however, account for certain urgent, priority spending, such as defense and homeland security, called for by the President and now moving through Congress. These priorities – which are accommodated in the House budget resolution – will create more deficit pressure. This in turn will require Congress to restrain additional spending beyond those demands – or risk longer, and deeper, deficits.

Key points to be drawn from CBO's report are the following:

- **This Sobering News Confirms the Need to Restrain Spending.** The triple shock of the economic slowdown, the terrorist attacks, and the war against terrorism pushed the budget into deficit. CBO estimates deficits of $157 billion this year, falling to $145 billion next year. Deficits will continue declining, until the budget returns to surplus in 2006 (see chart on the next page). But faster spending growth than CBO assumes will risk larger and longer-term deficits.

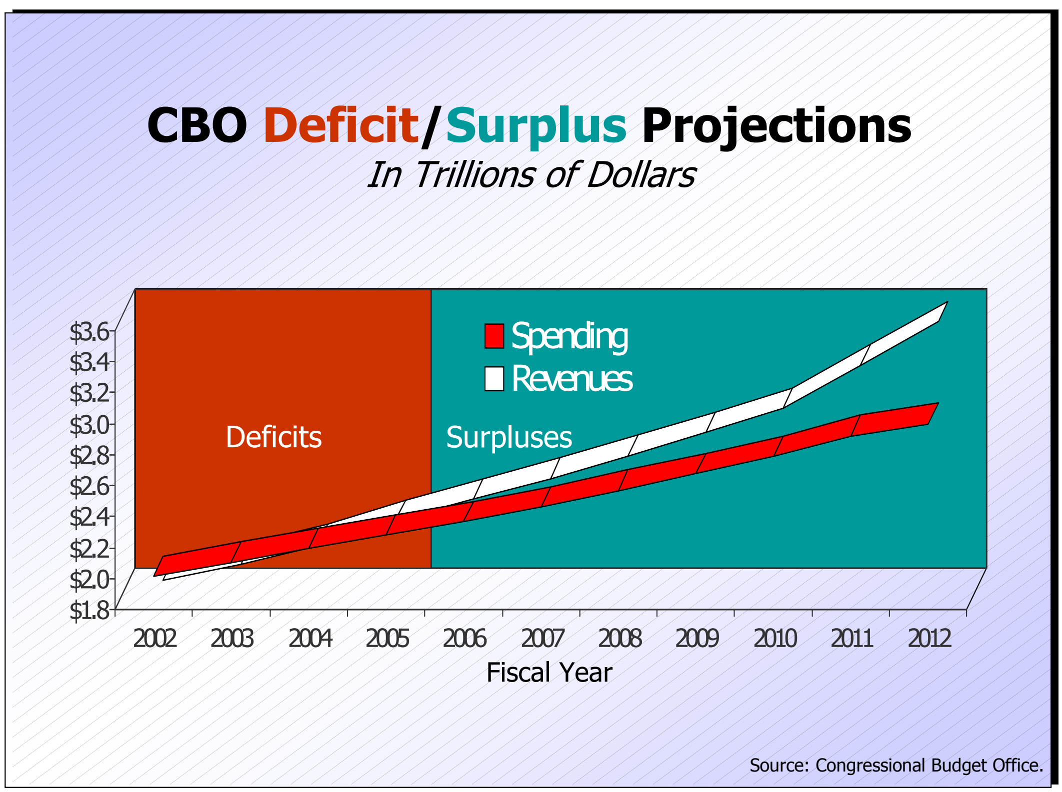
- **CBO Estimates a Slower Economic Recovery.** CBO estimates the economy may grow at a slower rate than projected by the administration, private forecasters, and the Federal Reserve. CBO's estimates incorporate recent (end-of-July) data revisions showing that the pace of economic growth was slipping faster in 2000 than previously recognized, and that the recession of 2001 was more severe – conditions outside of Congress's control. It is impossible to know whose economic projection will turn out to be most accurate. But

CBO's view does provide a warning against generating more economic uncertainty – by proposing tax increases, for example – while the economy is still recovering.

- **The Budget Trends Are Similar.** Even though CBO differs with the administration concerning the size and duration of deficits, both project a similar pattern – with deficits declining and becoming surpluses around the middle of the decade.

- **We *Must* Control What We *Can* Control.** The budget doesn't drive the economy, which drives the growth of Federal revenue; and Congress must continue to meet the Nation's urgent obligations to fighting the war against terrorism, protecting the homeland, and funding the Nation's other top priorities. But Congress *can* control spending beyond those needs – and must do so, to restore long-term budget balance.

As always, it should be noted that projections are not predictions. All of these estimates provide a picture of what *should* happen if certain underlying assumptions hold up. Thus, they can project the budget's direction, but cannot predict any specific outcome with certainty. As CBO itself says in today's update: "These projections should be viewed cautiously. . . . They are not intended to be a forecast of future outcomes. Indeed, actual budget figures will almost certainly differ from CBO's baseline projections because of future economic developments, legislative actions, and technical errors in estimating." (CBO, *The Budget and Economic Outlook: An Update*, August 2002)



THE NEED TO RESTRAIN SPENDING

CBO's Projections

- As noted above, CBO estimates deficits of $157 billion this year, and $145 billion next year.

  - Deficits are projected to continue declining, with the Government achieving a surplus of $15 billion in 2006.

  - Overall, the Government is projected to run a total deficit of $229 billion for 2003-2007, and a total surplus of $1.015 trillion for 2003-2012, according to CBO's estimates.

- These figures, however, do not account for additional priority spending requested by the President and moving through Congress, such as funds for fighting the war against terrorism and protecting the homeland. As CBO describes it, its "baseline" estimate involves "extending current laws and policies into the future and estimating their effect on the budget." These figures are intended to provide what CBO calls a "neutral benchmark that lawmakers can use to measure the effects of proposed changes in revenue and spending policies." (CBO, *The Budget and Economic Outlook: An Update*, August 2002)

- Other key points about CBO's baseline estimates include the following:

  - It assumes the expiration of current budget disciplines – the pay-as-you-go [PAYGO] mechanism for entitlements and taxes, and the spending caps for most discretionary appropriations. Consequently, the estimate projects increases in entitlement programs to accommodate projected caseloads, economic factors, and any enacted changes in law; and inflationary growth for discretionary appropriations.

  - It assumes the funds provided for emergency activities remain permanently in the base for Government spending, even if they were intended as one-time events (such as rebuilding New York).

  - It does not assume certain urgent priority spending initiatives – such as additional measures for fighting the war against terrorism, or protecting the homeland – that have not yet been enacted.

  - It does not assume new entitlements that have not been enacted, such as Medicare prescription drugs.

Deficit Changes

- Partly due to the nature of this report – which updates the projections CBO made in the spring – the report focuses considerable attention on the changes in CBO's estimates since March (see discussion below, and table on the next page).

- CBO's surplus/deficit estimates, compared with the agency's March projections, have changed by $162 billion for this year, $151 billion for 2003, and about $1.4 trillion over 10 years. CBO provides the following accounting of these changes.

Spending Changes

- Changes in CBO's baseline since March have resulted in an increase in spending projections of $688 billion over 10 years. Most of this change is due to legislation enacted since February, and the corresponding debt-service costs.

- **Legislative** – Recently enacted legislation has resulted in an increase in spending projections of $534 billion over the next 10 years.

  - The largest spending bill is the 2002 Supplemental Appropriations Act for Further Recovery From and Response to Terrorist Attacks on the United States. It provides $24 billion in additional discretionary budget authority in 2002 and, under CBO's baseline, will cost $268 billion from 2003 through 2012.

  - Other spending items include: the Farm Security and Rural Investment Act of 2002, worker displacement assistance under the Trade Act of 2002, and unemployment assistance under the Job Creation and Worker Assistant Act.

- **Economic/Technical** – Economic and technical changes have resulted in an increase in spending projections of $154 billion over the next 10 years. Economic changes have resulted in a $141 billion decrease in spending projections. Technical changes have resulted in a $295 billion increase in spending projections.

  - Economic changes largely affected Social Security, Federal net interest costs, and discretionary spending projections over the next 10 years.

  - Social Security spending projections are lower due primarily to a decrease in wage growth projections which reduces the projected growth of Social Security benefits. Federal net interest costs are lower due to reduced projections of the interest rates on Treasury bills. Discretionary spending projections are lower as a result of lower inflation projections.

  - The largest technical change – an increase of $286 billion in spending projections – is due to debt-service costs associated with the technical changes that reduced projected revenues.

Revenue Changes

- Changes in CBO's baseline since March have resulted in a decrease in revenue projections of $678 billion.

- **Legislative** – The two major bills with revenue effects include the Job Creation and Worker Assistance Act of 2002 and, to a lesser extent, the Trade Act of 2002. These bills resulted in a decrease in revenues of $43 billion over 5 years and an increase in revenues of $7 billion over 10 years.

- **Economic/Technical** – CBO's new projections show that the tax receipts projection for this fiscal year was reduced by $104 billion because of "technical" estimation differences since March. These are differences that cannot be explained by other factors, although historical data show that technical receipts changes are closely related to the behavior of the economy – with large negative technicals in and around recession years and positive technicals when the economy is doing well. In addition, the technical effect also lowered receipts in the range of $60 billion to $75 billion each year for the remaining years of the projection through 2012. These unanticipated declines in revenues had no relation to the tax cuts passed last year and were beyond the control of policy makers.

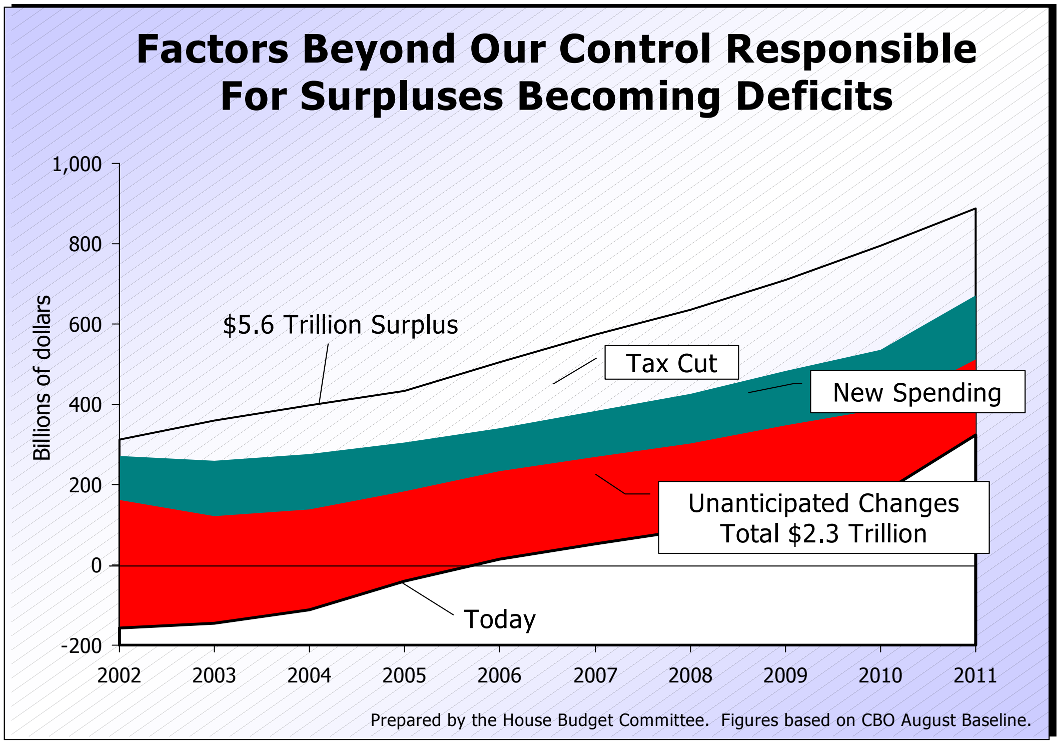
Changes in CBO's Baseline Projections of the Surplus Since March 2002
(In billions of dollars)

	2002	2003	2004	2005	2006	2007	Total, 2003-2007	Total, 2003-2012
Total Surplus as Projected in March 2002	5	6	61	111	135	175	489	2,380
Changes								
Revenues								
Legislative	-43	-40	-30	-4	15	16	-43	7
Economic	*	-22	-35	-32	-20	-10	-119	-16
Technical	-104	-61	-61	-62	-61	-62	-307	-668
Total	**-146**	**-124**	**-126**	**-98**	**-66**	**-56**	**-469**	**-678**
Outlays								
Discretionary spending								
Supplemental appropriations	6	23	23	25	26	27	123	268
Other	-4	-2	-3	-4	-4	-3	-16	-19
Subtotal	2	21	19	21	22	24	108	250
Debt service	1	13	23	27	33	40	136	456
Other	13	-6	4	5	-1	4	5	-18
Total	**16**	**28**	**47**	**52**	**54**	**68**	**249**	**688**
Total Effect on the Surplus	**-162**	**-151**	**-173**	**-150**	**-120**	**-123**	**-718**	**-1,366**
Total Surplus or Deficit (-) as Projected in August 2002	-157	-145	-111	-39	15	52	-229	1,015
Memorandum:								
Changes in Outlays Because of Supplemental Appropriations, by Type of Discretionary Spending								
Defense	5	15	14	14	14	15	73	153
Nondefense	1	7	8	10	12	12	50	116

Note: * = between -$500 million and $500 million.

Source: Congressional Budget Office.

- Since early 2001, much of the budget surplus then projected – an estimated $5.6 trillion – has been lost. As the chart below shows, the vast majority of this decline has resulted from unanticipated economic factors, and higher spending demands (see chart below).



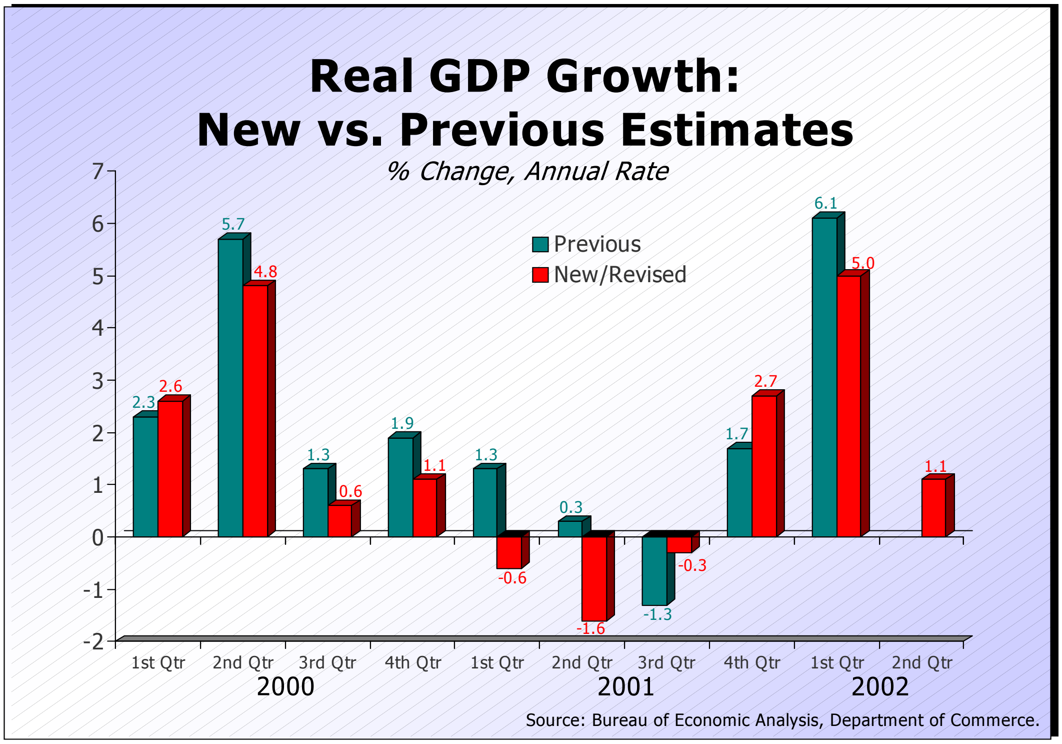
A POTENTIALLY SLOWER ECONOMIC RECOVERY

CBO's Estimates

- CBO now estimates real GDP growth of 2.3 percent this year, somewhat better than its projection in March of 1.7 percent.

- For next year, however, CBO estimates 3.0-percent real GDP growth – somewhat less than its 3.4-percent estimate in March.

- Much of the change in CBO's economic projection results from the inclusion of revised economic data, reported at the end of July, showing that the pace of economic growth was slipping much faster in 2000 than previously recognized, and the recession of 2001 was more severe (see chart on the next page).



- The principal effect of those revisions, however, has been to reduce the share of national income devoted to wages and salaries and to profits, which are taxable at high rates. The revised data showed a decline in those income shares, which helps explain a decline in Federal revenue.

- In summary, CBO's update today says: "The Congressional Budget Office believes that the economy will continue its modest recovery this year and will return to more robust growth next year." (CBO, *The Budget and Economic Outlook: An Update*, August 2002)

A Brief Summary of the Past 2 Years

- One way to gain perspective on the budget and economic conditions of today is to reflect on the dramatic changes that occurred over the past 2 years.

- In 2000, most analysts recognized that the pace of economic growth was slowing. But it was not until the end of July this year that the size of the decline was evident.

- Those revised figures also show that the magnitude of the slowdown and recession was more pronounced than previously recognized. It should be noted that early in his administration, President Bush was urging tax reduction to stem the slowdown.

- Nevertheless, last summer's budget and economic conditions appeared to be sound:

  - CBO estimated that real GDP would grow about 1.7 percent in 2001, 2.6 percent in 2002, and an average of 3.2 percent for 2003-2006.

  - CBO also estimated budget surpluses of $176 billion in 2002, and $3.4 trillion over 10 years, *even after accounting for the President's tax cut package.*

- The events of September 11 represented a major turning point in these trends – a shock to the budget and economic situation.

  - The terrorist attacks created a national emergency and led to a war against terrorism.

  - Those events also led to bipartisan spending initiatives to enhance homeland security.

  - In addition, Congress and the President in March enacted the Job Creation and Worker Assistance Act to support the economic recovery.

- These events have combined to create short-term budget deficits. The budget does not drive the economic recovery, which will help lead back toward budget surpluses. But Congress *can* control spending – and that is the only way to restore balance.

Economic Assumptions Comparisons

	2001 Actual	2002	2003
REAL GDP	*% Change, Fourth Quarter to Fourth Quarter*		
Administration (MSR July)	0.1	3.7	3.7
CBO (August)	0.1	2.9	3.4
Federal Reserve (July)	0.1	3-1/2 to 3-3/4	3-1/2 to 4
Blue Chip (August)	0.1	2.9	3.5
UNEMPLOYMENT RATE	*Fourth Quarter Level*		
Administration (MSR July)	5.6	5.8	5.5
CBO (August)	5.6	5.9*	5.9*
Federal Reserve (July)	5.6	5-3/4 to 6	5-1/4 to 5-1/2
Blue Chip (August)	5.6	6.0	5.5
TAXABLE INCOME SHARES	*Annual Average Level*		
Administration (MSR July)			
Wages & Salaries	49.9	49.4	49.6
Corporate Profits, Book	6.8	6.9	7.9
CBO (August)			
Wages & Salaries	49.1	48.3	48.4
Corporate Profits, Book	6.6	5.9	6.1

Note: * = Annual average unemployment rate for CBO, not fourth quarter value.

Sources: CBO, OMB, Blue Chip Economic Indicators, Federal Reserve.

SIMILARITY OF BUDGET TRENDS

- CBO and the administration always differ at least slightly in their specific budgetary estimates, and that is true in comparing CBO's figures today with those the administration released in July.

- Still, both sets of estimates show declining budget deficits, and a return to budget surpluses by the middle of the decade. The administration estimates a surplus of $53 billion in 2005. CBO estimates a surplus of $15 billion in 2006.

- One reason for the difference is that CBO and the administration employ different economic assumptions, which affect rates of growth in both spending and taxes, among other things.

  - Note that even a slight difference in economics can change estimates by tens of billions of dollars out of a $2-trillion budget in a $10-trillion economy.

  - As noted above, CBO's estimates include recent (end of July) Department of Commerce data showing that the pace of economic growth was slipping faster in 2000 than previously recognized, and that the recession of 2001 was more severe. This also affects CBO's projection of future growth and the expected level of Federal revenue.

- But the two agencies develop their figures for fundamentally different purposes:

  - The administration's Office of Management and Budget [OMB] uses a so-called "post-policy" projection, meaning – to put it simply – it assumes the spending effects of its own policy proposals. Consequently, the administration's deficit and surplus projections already take into account the President's proposed policy initiatives, including his proposed levels of spending restraint.

  - CBO, on the other hand, uses its so-called "baseline," which counts programs already in effect and new programs that have been signed into law. CBO assumes that entitlements in this category will grow as required by law and economic/demographic factors, and that all discretionary spending – including amounts for supposedly one-time emergencies – will grow with inflation.

Projections Are Not Predictions

- All these budget and economic projections are only estimates of what should happen assuming conditions unfold as expected.

- As such, they provide a sense of the direction that the budget and the economy are taking, but should not be taken as specific predictions. They are useful as a guide to policymakers, but should not be taken as absolutes.